

**Tennessee Board of Regents
Endowment for Educational Excellence
Tennessee State University Foundation**

**For the Eight Months Ended February 29, 2004, and
the Years Ended June 30, 2003, and June 30, 2002**

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

July 12, 2004

Dr. Charles W. Manning, Chancellor
Tennessee Board of Regents
1415 Murfreesboro Road, Suite 350
Nashville, Tennessee 37217

Dear Dr. Manning:

Transmitted herewith is the report on the Endowment for Educational Excellence at the Tennessee State University Foundation for the eight months ended February 29, 2004, and the years ended June 30, 2003, and June 30, 2002. The audit was conducted under the requirements of the trust agreement which established the endowment. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

The Questions and Responses section addresses the questions that were asked by the Tennessee Board of Regents regarding the management of and the accounting for the endowment. In accordance with the agreement between the foundation and Tennessee State University, the university maintains the foundation's accounting records.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/sah
04/104

cc: Dr. Robert H. Adams
Vice Chancellor for Business and Finance
Tennessee Board of Regents



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
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Independent Auditor's Report

June 17, 2004

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

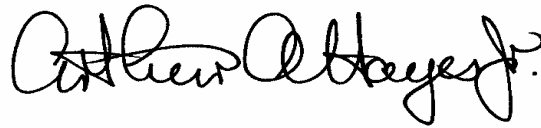
We have audited the accompanying statements of net assets of the Endowment for Educational Excellence at the Tennessee State University Foundation as of February 29, 2004, June 30, 2003, and June 30, 2002, and the related statements of revenues, expenses, and changes in net assets for the eight months ended February 29, 2004, and the years ended June 30, 2003, and June 30, 2002. These financial statements are the responsibility of the foundation's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Honorable John G. Morgan
June 17, 2004
Page Two

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Endowment for Educational Excellence at Tennessee State University Foundation as of February 29, 2004, June 30, 2003, and June 30, 2002, and the changes in financial position for the eight months ended February 29, 2004, and the years ended June 30, 2003, and June 30, 2002, in conformity with accounting principles generally accepted in the United States of America.

Sincerely,

A handwritten signature in black ink, reading "Arthur A. Hayes, Jr." in a cursive script.

Arthur A. Hayes, Jr., CPA,
Director

AAH/sah

**TENNESSEE BOARD OF REGENTS
ENDOWMENT FOR EDUCATIONAL EXCELLENCE
TENNESSEE STATE UNIVERSITY FOUNDATION
STATEMENTS OF NET ASSETS
FEBRUARY 29, 2004, JUNE 30, 2003, AND JUNE 30, 2002**

	<u>February 29, 2004</u>	<u>June 30, 2003</u>	<u>June 30, 2002</u>
ASSETS			
Current assets:			
Accrued interest receivable	\$ 22,227.08	\$ 9,246.61	\$ 6,873.97
Total current assets	<u>22,227.08</u>	<u>9,246.61</u>	<u>6,873.97</u>
Noncurrent assets:			
Cash and cash equivalents (Notes 2 and 3)	4,898,047.17	817,488.20	672,879.59
Investments (Note 4)	4,250,215.19	3,669,773.50	1,278,958.52
Receivable from current funds	-	565,671.25	-
Accounts receivable (Note 5)	-	1,007,852.86	-
Total noncurrent assets	<u>9,148,262.36</u>	<u>6,060,785.81</u>	<u>1,951,838.11</u>
Total assets	<u>9,170,489.44</u>	<u>6,070,032.42</u>	<u>1,958,712.08</u>
LIABILITIES			
Current liabilities:			
Payable to other endowments	-	-	280.71
Total current liabilities	<u>-</u>	<u>-</u>	<u>280.71</u>
Total liabilities	<u>-</u>	<u>-</u>	<u>280.71</u>
NET ASSETS			
Restricted for:			
Nonexpendable:			
Scholarships and fellowships	9,170,489.44	6,070,032.42	1,958,431.37
Total net assets	<u>\$ 9,170,489.44</u>	<u>\$ 6,070,032.42</u>	<u>\$ 1,958,431.37</u>

The notes to the financial statements are an integral part of this statement.

TENNESSEE BOARD OF REGENTS
ENDOWMENT FOR EDUCATIONAL EXCELLENCE
TENNESSEE STATE UNIVERSITY FOUNDATION
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE EIGHT MONTHS ENDED FEBRUARY 29, 2004, AND
THE YEARS ENDED JUNE 30, 2003, AND JUNE 30, 2002

	Eight Months Ended <u>February 29, 2004</u>	Year Ended <u>June 30, 2003</u>	Year Ended <u>June 30, 2002</u>
NONOPERATING REVENUES (EXPENSES)			
State appropriations	\$ 1,000,000.00	\$ 2,007,852.86	\$ 1,000,000.00
Gifts	450.00	597,404.35	-
Grants and contracts	1,762,878.00	1,000,000.00	1,000,000.00
Investment income	116,158.58	6,544.14	7,079.42
Other nonoperating revenues (expenses)	<u>220,970.44</u>	<u>499,799.70</u>	<u>(48,648.05)</u>
Net nonoperating revenues	<u>3,100,457.02</u>	<u>4,111,601.05</u>	<u>1,958,431.37</u>
Increase in net assets	<u>3,100,457.02</u>	<u>4,111,601.05</u>	<u>1,958,431.37</u>
NET ASSETS			
Net assets - beginning of year	6,070,032.42	1,958,431.37	-
Net assets - end of year	\$ <u><u>9,170,489.44</u></u>	\$ <u><u>6,070,032.42</u></u>	\$ <u><u>1,958,431.37</u></u>

The notes to the financial statements are an integral part of this statement.

**Tennessee Board of Regents
Endowment for Educational Excellence
Tennessee State University Foundation
Notes to the Financial Statements
February 29, 2004, June 30, 2003, and June 30, 2002**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Endowment for Educational Excellence is a part of the Tennessee State University Foundation. The endowment was created during the fiscal year ended June 30, 2002, as a part of the Geier Consent Decree. The trust agreement which created the endowment was entered into in December 2001 between the Tennessee Board of Regents and the Tennessee State University Foundation, which was designated as the trustee.

Basis of Presentation

The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board (GASB).

Basis of Accounting

The financial statements have been prepared using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned, and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. The foundation has the option of following private-sector guidance issued subsequent to November 30, 1989, subject to the above limitation. The foundation has elected not to follow private-sector guidance issued subsequent to November 30, 1989.

The endowment's activity is nonoperating in nature and includes (1) state appropriations provided as a part of the consent decree, (2) federal grant funds from the U.S. Department of Education under the Title III Strengthening Historically Black Colleges and Universities Program, (3) investment income, and (4) gifts.

**Tennessee Board of Regents
Endowment for Educational Excellence
Tennessee State University Foundation
Notes to the Financial Statements (Cont.)
February 29, 2004, June 30, 2003, and June 30, 2002**

Net Assets

The endowment's net assets are classified as nonexpendable restricted net assets. Nonexpendable restricted net assets consist of endowment and similar type funds in which donors or other outside sources have stipulated, as a condition of the gift instrument, that the principal is to be maintained inviolate and in perpetuity, and invested for the purpose of producing present and future income, which may be expendable or added to principal. The trust agreement does provide for spending a portion of the income, as discussed in Note 6. Spending decisions are to be made by the Budget Committee established in the trust agreement through the preparation of an annual budget. However, as of February 29, 2004, no funds have been designated to be spent.

NOTE 2. CASH AND CASH EQUIVALENTS

In addition to demand deposits, this classification includes instruments which are readily convertible to known amounts of cash and which have original maturities of three months or less. At February 29, 2004, cash and cash equivalents consisted of \$169.29 in bank accounts and \$4,897,877.88 in capital management account money funds. At June 30, 2003, cash and cash equivalents consisted of \$413,340.55 in bank accounts, \$444.63 in the State of Tennessee Local Government Investment Pool administered by the State Treasurer, and \$403,703.02 in capital management account money funds. At June 30, 2002, cash and cash equivalents consisted of \$672,879.59 in capital management account money funds.

NOTE 3. DEPOSITS

Some of the foundation's deposits are in financial institutions that participate in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure.

The laws of the State of Tennessee require that collateral be pledged to secure all uninsured deposits. Tennessee Board of Regents policies require that the market value of collateral pledged equal 115%, 100%, or 90% of the uninsured deposits at

**Tennessee Board of Regents
Endowment for Educational Excellence
Tennessee State University Foundation
Notes to the Financial Statements (Cont.)
February 29, 2004, June 30, 2003, and June 30, 2002**

financial institutions participating in the collateral pool. The pledge level is based on financial criteria set by the Collateral Pool Board with the financially strongest institutions being eligible for the lowest pledge level.

Deposits with financial institutions are required to be categorized to indicate the level of risk assumed by the foundation. Category 1 consists of deposits that are insured or collateralized with securities held by the foundation or by its agent in the foundation's name. Category 3 deposits are uncollateralized. This category includes any bank balance that is collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the foundation's name.

At February 29, 2004, the carrying amount of the endowment's portion of the foundation's deposits was \$2,891,246.71, and the bank balance was \$2,891,246.71. Of the bank balance, \$1,221,766.39 was category 1, and \$1,669,480.32 was category 3. At June 30, 2003, the carrying amount of the endowment's portion of the foundation's deposits was \$817,043.57, and the bank balance was \$817,043.57. The bank balance was category 1. At June 30, 2002, the carrying amount of the endowment's portion of the foundation's deposits was \$672,879.59, and the bank balance was \$672,879.59. The bank balance was category 1.

The foundation also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. The LGIP is part of the Pooled Investment Fund. The fund's investment policy and custodial credit risk are presented in the *Tennessee Comprehensive Annual Financial Report*. That report may be obtained by writing to the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298, or by calling (615) 741-2140.

NOTE 4. INVESTMENTS

The trust agreement requires that the foundation delegate the actual management of the endowment assets to one or more professional investment managers, which are to be selected on the basis of demonstrated performance, management philosophy, investment style, and fees. As of February 29, 2004, the endowment assets were under the management of three banks and one investment company. The foundation is authorized to invest the endowment funds in accordance with the trust agreement. Under the trust agreement, the foundation is authorized to invest and reinvest the property of the trust in any kind of real and/or personal property and any kind of investment specifically including, but not limited to, domestic or foreign government

**Tennessee Board of Regents
Endowment for Educational Excellence
Tennessee State University Foundation
Notes to the Financial Statements (Cont.)
February 29, 2004, June 30, 2003, and June 30, 2002**

obligations of any kind; domestic or foreign securities of any kind including, but not limited to, preferred or common stocks, bonds, mortgage participations and shares of investment trusts, investment companies, money market funds, mutual funds (including market or index funds); options to purchase or sell domestic or foreign securities or domestic or foreign government obligations of any kind; and interests in partnerships, so long as such investments are made with the care of a fiduciary.

All investments permitted to be reported at fair value under GASB Statement 31 are reported at fair value, including those with a maturity date of one year or less at the time of purchase.

The foundation's investments related to the endowment are categorized below to indicate the level of risk assumed by the foundation at year-end. Category 2 consists of uninsured and unregistered investments for which the securities are held by the counterparties' trust department or agent in the foundation's name.

February 29, 2004

Category 2:	
U.S. government securities	\$ 911,905.95
Corporate bonds	1,054,872.75
Corporate stocks	1,908,624.93
Mortgage backed securities	108,448.38
Investments not susceptible to credit risk categorization:	
Mutual funds	<u>266,363.18</u>
Total	<u><u>\$ 4,250,215.19</u></u>

June 30, 2003

Category 2:	
U.S. government securities	\$ 919,795.42
Corporate bonds	936,368.25
Corporate stocks	1,405,193.12
Mortgage backed securities	160,175.60
Investments not susceptible to credit risk categorization:	
Mutual funds	<u>248,241.11</u>
Total	<u><u>\$ 3,699,773.50</u></u>

**Tennessee Board of Regents
Endowment for Educational Excellence
Tennessee State University Foundation
Notes to the Financial Statements (Cont.)
February 29, 2004, June 30, 2003, and June 30, 2002**

June 30, 2002

Category 2:	
U.S. government securities	\$ 102,281.00
Corporate bonds	555,360.15
Corporate stocks	513,898.75
Investments not susceptible to credit risk categorization:	
Mutual funds	<u>107,418.62</u>
Total	<u>\$ 1,278,958.52</u>

NOTE 5. RECEIVABLES

The receivable at June 30, 2003, was for state appropriations that were due to match the private donations to the endowment.

NOTE 6. ENDOWMENT INCOME

The trust agreement requires that at least 25% of the annual endowment income be added to the corpus and stipulates approved and prohibited uses of the other 75%. The grant agreement for the Title III program requires that 50% of the endowment income be added to the corpus and has provisions on the allowable uses of the other 50%. As of February 29, 2004, none of the endowment income has been spent.

QUESTIONS AND RESPONSES REGARDING THE GEIER ENDOWMENT FOR EDUCATIONAL EXCELLENCE AT TENNESSEE STATE UNIVERSITY FOUNDATION

Question 1 – Have all funds (whether state, federal grants, or private gifts) that have been earmarked for the Geier Endowment actually been placed in the Geier trust?

Yes. The corpus of the endowment comes from three funding sources: (1) the State of Tennessee, which consists of two components: (a) ten million dollars, which is paid to the endowment at a rate of one million dollars a year for ten years, and (b) an additional ten million dollars, which can be obtained from the state, as a match, if private donations are collected; (2) the U.S. Department of Education under the Title III Strengthening Historically Black Colleges and Universities Program; and (3) private donations. Based on the procedures performed, the funds received from each of these sources have been placed in the accounts related to the Geier trust.

Question 2 – Are Geier Funds properly segregated on the foundation accounting records from other endowment or operating funds of the foundation?

Yes. Based on the procedures performed, Geier funds appear to be properly segregated on the foundation's accounting records.

Question 3 – Are the Geier Funds invested only in investment instruments authorized by the trust agreement?

The Trust Agreement, Article 6, Section 6.1(b) specifies the types of investment instruments which are authorized. Based on the procedures performed, the investments for the Geier Endowment for Educational Excellence were invested only in authorized instruments, once they were placed with professional investment managers. However, for some periods of time, the funds have been held in the Local Government Investment Pool, administered by the State Treasurer, as discussed in the response to Question 4, and the Trust Agreement does not specifically address that type of investment.

Question 4 – Are adequate procedures in place to ensure timely investment of cash balances?

Based on the procedures performed, Geier funds appear to be invested timely. However, cash of \$2,007,852.86 received from the state in July 2003, which was originally transferred into the university's Local Government Investment Pool (LGIP) account, was not transferred to one of the endowment's investment managers until February 2004. Foundation staff stated the delay was due to the issuance of Requests for Proposal for two new investment managers. In addition, \$1,000,000 of state contributions received in January 2003 was not placed with an investment manager until April 2003. Although the funds were invested in LGIP, the Trust Agreement

requires the foundation to delegate the management of the endowment assets to one or more professional investment managers, as discussed in the response to Question 5, and the LGIP has not officially been designated as such by the board.

Question 5 – Is there adequate supporting documentation regarding how investment decisions are made by the Foundation Board?

The Foundation Board does not make individual investment decisions. In the Trust Agreement, Article 3, Section 3.1 requires the foundation to delegate the actual management of the endowment assets to one or more professional investment managers. In accordance with the Trust Agreement, the foundation maintains investment accounts with three banks and one investment company, and the investment managers are responsible for the day-to-day investing activities. The foundation board has established an investment philosophy and provided the investment managers with information on the authorized investments stipulated in the Trust Agreement.

Question 6 – Do investment reports agree to general ledger balances in the accounting records?

Yes. Based on the procedures performed, the general ledger balances are supported by the investment reports.

Question 7 – Are earnings from the investment accounts properly recorded in the accounting records?

Yes. Based on the procedures performed, the earnings from the Geier investment accounts are properly recorded in the accounting records. The funds related to Geier are in separate investment accounts so that gains and losses on the investments and the investment income can be tracked.

As noted in the response to Question 4, Geier funds are sometimes invested in the university's LGIP account for a period of time. In these cases, the university makes an interest allocation for the amounts earned while the funds are in the LGIP account. Based on the procedures performed, interest on the state funds was allocated to the Geier endowment in FY 2003 and FY 2002; however, the university has not yet prepared the allocation for FY 2004. It is the university's practice to allocate LGIP interest at the end of each fiscal year. For the purposes of the financial statements in this report, an estimate of the allocation was made.

Question 8 – Are donor restrictions properly recognized in the accounting system to ensure compliance with donor wishes?

As noted in the response to Question 1, the amounts received from the three sources discussed have been properly included in the Endowment for Educational Excellence, in which the funds

are classified as restricted and nonexpendable. The only source which may be in question relates to the transfer of private donations in July 2003, which is addressed in the response to Question 9.

The investment income earned on the endowment is classified as restricted; some is nonexpendable and some is expendable. The Trust Agreement requires that at least 25% of the income be added to the corpus and stipulates approved and prohibited uses of the other 75%. The grant agreement for the Title III program requires that 50% of the income be added to the corpus and has provisions on the allowable uses of the other 50%. As of February 29, 2004, none of the income has been expended.

Question 9 – Was the transfer of private funds of approximately \$1 million in July of 2003 to the Geier Endowment accomplished in accordance with donor designations?

In order to obtain matching funds from the state (one of the two components of state funds as discussed in the response to Question 1), the foundation had to obtain funds from private donations, which were to be made a part of the Endowment for Educational Excellence. The foundation obtained the matching funds from other endowment accounts which were already established for the foundation. Written consent was obtained from the donors for those endowment accounts to transfer the funds to the Endowment for Educational Excellence so that the foundation would be able to obtain the matching funds from the state. Based on their consent to the transfer of their endowment accounts, it would appear that these donors authorized the use of their endowment accounts for the Geier trust; however, there appears to be some question as to whether all of the donors realized that their original endowment would no longer be intact after the transfer. The ultimate propriety of the transfer and the related legal consequences should be addressed by the State Attorney General, the Tennessee Higher Education Commission, and the Tennessee Board of Regents.

Question 10 – Is there an adequate system of internal controls and proper segregation of duties for the accounting and management of these funds?

An organization's internal controls consist of several components: the control environment, risk assessment, control activities, information and communication, and monitoring. Furthermore, the effectiveness of the controls is dependent upon two factors: design and operation.

Even a well designed internal control can be rendered ineffective by the way it is implemented. Considerations such as the competency of staff, their attention to detail, and proactive execution of their duties as well as the attitude of upper management (tone at the top) all serve to either enhance or detract from the effectiveness of a well designed internal control. And these variables can change materially over time. For these reasons, the ultimate effectiveness of internal controls is the responsibility of upper management. To this end, upper management should take all steps to assure themselves, on a regular basis, that the controls are working as designed, that they are promptly informed of problems, and that they take appropriate timely corrective actions when necessary.

These conditions are true for any system of internal controls. In light of the nature of these funds and the programs they support, top management should be particularly sensitive to the need for good controls in this area of operations. Furthermore, they should notify appropriate external parties, including, but not limited to, the Division of State Audit, when there are any control failures or other problems with this program.

As noted below, this office has disclosed problems with internal controls in other operations of the university which could impact this program. To date there have been relatively few transactions related to this program. As this program proceeds, these weaknesses and other, as yet unforeseen, problems could negatively affect the program and the recording of program related transactions. In light of this history and the relative newness of this program, our comments on the controls existing at the time of our fieldwork should be viewed in that perspective.

In accordance with the agreement between the foundation and Tennessee State University, the university maintains the foundation's accounting records. Therefore, the transactions related to the endowment are processed through the university's system based on initiation by foundation staff and approval by foundation management, which does appear to provide proper segregation of duties. In addition, as discussed in the response to Question 5, the management of the endowment assets is delegated to professional investment managers, as required by the Trust Agreement. However, it was noted that the foundation does not periodically monitor the investments maintained by the investment managers. Such monitoring would ensure the investments are in compliance with the requirements of the Trust Agreement.

For the period July 1, 2001, through February 29, 2004, the only transactions related to the endowment involved the receipt of funds from the sources discussed in the response to Question 1, the investment of those funds, and transactions related to the investments such as gains and losses and investment income. The university's audit report for the fiscal year ended June 30, 2003 had a finding on the foundation's lack of adequate procedures for recording and reconciling revenues and maintaining documentation. Due to the nature of the transactions noted above for the endowment, this finding did not appear to impact the endowment for the period examined, but it could possibly impact future transactions if not corrected.

In the Trust Agreement, Article 5, Section 5.1 provides for the establishment of a Budget Committee for the endowment, and Article 5.2(a) establishes the specific powers of the committee, which include determining how the trust fund income will be allocated among the various approved purposes of the trust. As of February 29, 2004, none of the income has been expended. The university's audit report for the fiscal year ended June 30, 2003 had a finding on the foundation regarding problems with the awarding of scholarships. Since none of the endowment income had been expended for the period examined, this finding did not appear to impact the endowment. However, since the awarding of merit-based academic scholarships is one of the approved uses of endowment income, it could possibly impact future transactions if not corrected.